Discussion

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The paper presented by Nick Lardy at the conference touched upon a significant issue relating to the transformation of the Chinese economy, namely the rising private sector. If we can use one single measure gauging the progress of transition from a centrally planned to a market economy, that measure is the changing share of the private sector as compared with the share of the state sector in the economy. Lardy began by arguing that the expanding scope of markets and the growing role of private firms operating in these markets have been a major source of economic growth in the reform era. He then asks whether or not the earlier trends of such developments have continued in recent years and what this implies for China's growth going forward.

Lardy presents data on total output, employment and exports to show the rise of the private sector relative to the state-owned sector. He then provides explanations as to why the private sector dominates these measures, including: the evolution of state policy towards accommodating private sector development – in part through constitutional amendments; the greater efficiency of private firms as measured by the higher total factor productivity growth and a higher return on assets; and financial measures indicating that private firms have been twice as creditworthy as state firms in recent years.

Lardy also shows that the long-term trends have largely continued in more recent developments. Notwithstanding this, the author points out two worrying trends in the Chinese economy in more recent times. The first is that the rate of expansion of private firms' share of investment has moderated to a pace far below the first three decades of economic reform; and the second is that the productivity gap between the state and private sectors has widened substantially over the past decade, largely because the return on assets of state companies declined while that of private firms continued to rise. Lardy argues that the rapid increase of indebtedness of state firms poses a real concern.

My first question about the paper relates to the estimated employment figures. Lardy points out that China's employment data are among the most problematic. He has gone to great effort to estimate employment for private firms, and for state-owned and state-controlled firms in urban areas. According to these estimates, private firms employed 253 million workers in 2011 (about two-thirds of China's urban labour force), while state firms employed 45.1 million workers (12.5 per cent of the urban labour force). Together the two categories account for 78.5 per cent of the urban workforce. It is unclear whether the remaining share is made up of self-employed workers and how the large number of migrant workers fit into the calculations.

The second question relates to the interest coverage ratio (the ratio of a firm's earnings before interest and taxes to its interest expense). According to the calculation, in the industrial sector, private firms have been twice as creditworthy as state firms in recent years. However, the calculation is based on the official data, which could substantially underestimate the interest expense paid by the private firms, as the funds may be borrowed from the informal financial sector, which charges much higher interest rates than the major banks.

The third question is related to the leverage ratio, which is the ratio of firms' liabilities to equity. The data show that the leverage ratio of state industrial firms has risen significantly since 2007, while on average the leverage ratio of private firms is declining. This is because private firms have had much higher returns, which in turn led to higher retained earnings. However, during the current economic slowdown, many private firms have also performed poorly. That may alter the pattern of the relative performance of private and state firms' leverage ratios.

Finally, I think the paper would benefit from some more exploration of why state-controlled firms performed worse when compared with other types of firms according to the estimates of the paper.

Overall, I agree that the moderation of the rate of expansion of private firms' share of investment is a key concern. To further increase the share of the private sector in the economy, I believe that China needs to create an environment in which entrepreneurship can flourish (Song 2015). To do this, the authorities need to further reform government–business relations, the financial and regulatory system, and market conditions. This would allow the 'creative destruction' process to take place, such that private entrepreneurs can devote their efforts to more 'productive' rather than 'unproductive' or even 'destructive' activities. The development of entrepreneurship is also influenced by cultural factors such as risk tolerance and patience. This raises an issue as to whether generations of single children (due to the family planning policy) will become more entrepreneurial and aid the rise of the private sector in China.

References

Song L (2015), 'State and Non-State Enterprises in China's Economic Transition', in GC Chow and DH Perkins (eds), *Routledge Handbook of the Chinese Economy*, Routledge Handbooks, Routledge, London, pp 182–207.

2. General Discussion

Discussion initially focused on the allocation of credit to private firms in China. Some participants noted that anecdotal evidence of private firms having difficulty gaining access to credit in China contrasts with the finding in the paper that the share of credit allocated to private firms is increasing. One participant noted that banks have an incentive to lend to state-owned enterprises (SOEs) rather than private companies. The participant also questioned how attempts to control the growth of shadow banking might affect the cost of capital for the private sector, given it is thought that this type of financing is more common for private firms.

Another participant noted that while the financial services sector has grown as a share of the Chinese economy and is approaching the level of advanced economies, there continues to be excess demand for credit from the private sector. The participant also noted that recent growth in bank assets may provide further evidence of growth in credit extended to the private sector. In that context, they questioned whether the focus on deleveraging should be reduced if a larger share of credit is being allocated to productive private firms.

Nicholas Lardy agreed that the conventional wisdom was that banks only lent to state companies but asserted that while this tended to be the case in the past, it was no longer true. He did, however, note that SOEs may still be getting too much credit relative to their contribution to output. Dr Lardy added that bond issuance was still more heavily weighted to the state and that limited access to credit was an issue often raised by private firms. However, he recognised that this was also a common complaint of small private businesses in market economies.

One participant queried how the decline of the state sector should be interpreted. In particular, the participant suggested that even though the share of the state sector was declining, its effect on the overall macroeconomy was not. The participant believed that the state sector's contribution to output had been declining even faster than the proportion of the resources it was using, particularly financial resources. Dr Lardy agreed that, while the share of the state has been declining across a range of measures, it has become a bigger drag on economic growth. He also suggested that poorly performing 'zombie' firms should be subject to more competition with private firms.

On the current economic environment, one participant raised the notion that if a new round of stimulus were implemented in order to boost the economy, then the private sector might be squeezed out by the state sector, as seemed to be the case in the last round of stimulus. Dr Lardy disagreed that private companies were squeezed following the global financial crisis, pointing out that the share of lending going to private companies continued to increase in 2010, 2011 and 2012.

Participants also commented on reform. It was noted by one participant that although the government has spent considerable resources and energy to reform SOEs, the policy focus should instead be on creating a better environment for the expansion of the private sector. Another participant questioned whether the private sector could continue to expand and whether the reforms of SOEs seemed to be reaching a limit.

A number of participants commented on the productivity of state and private firms in China. One participant questioned whether the decline in total factor productivity (TFP) in the 2007–12 period presented in Harry Wu's paper (this volume) was due to declining TFP in the state sector, the private sector or both. The participant suggested the possibility that the private sector is increasingly led by government regulations and incentives to move into particular industries, which do not necessarily have the highest TFP. Another participant suggested that outsourcing of the most profitable activities of state firms to private firms could be contributing to the difference between their productivity.

Finally, one participant questioned how the distinction between state and private control of a firm was made when the state owned less than half of the company, but was the largest single shareholder. Dr Lardy provided details about how he distinguished between state control and private control as set out in his paper. Dr Lardy argued that the methods used to define who controlled a firm in his paper were sensible and that the role of state-controlled companies in the economy would not be understated.